

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Fixed Income –
Securities Lending Program Annual Report

ITEM NUMBER: 6

ATTACHMENT(S): 4

ACTION: X

DATE OF MEETING: May 1, 2002

INFORMATION: _____

PRESENTER(S): Michelle Cunningham
Glenn Hosokawa

EXECUTIVE SUMMARY

One of the objectives approved for the Investment Branch for Fiscal Year 2001/02 is to present an Annual Report on the California State Teachers' Retirement System (CalSTRS, System) Securities Lending Program. **Attachment 1** is intended to fulfill that objective, and is presented for the Committee's information.

In addition, based upon Board Policy, which states that such policies shall be reviewed periodically (the last update to the Securities Lending Policy Manual was on May 5, 1999), staff is also submitting an updated Securities Lending Policy Manual. The updated policy reflects cosmetic changes made in order to make the format consistent with other recent policy updates. **Attachment 2** represents a marked-up Securities Lending Policy Manual, illustrating staff's suggestions; **Attachment 3** is the proposed revised Policy.

BACKGROUND

The CalSTRS Securities Lending Program represents the System's first non-core investment program, designed to enable the fund to use its existing asset base and investment expertise to generate incremental income. CalSTRS first began lending its assets, which were entirely domestic at the time, in 1988, through its Master Custodian. In 1990, another lender was included, with the intention of adding competition and diversification to the program. In 1992, as CalSTRS began investing internationally, the Securities Lending Program was expanded to include those assets as well. In 1997, the Investment Committee approved the internal management of a portion of the cash collateral proceeds within the Securities Lending Program. After more than a decade of managing multiple lenders, strategies and structures, CalSTRS issued a Request for Proposal (RFP) in 2000, for the securities lending of all available assets, which resulted in a restructuring of the program and an improved fee split for the Fund.

DISCUSSION


Last July, when staff presented its Securities Lending Business Plan to the Investment Committee, the main challenge identified going forward was the management of the quality of the incremental income earned by the program. The Securities Lending Program had undergone significant restructuring as a result of an RFP for Securities Lending Agents that was issued in 2000. One of the original lenders was terminated, one new lender was added, the assets being lent were redistributed, and a greater portion of the cash collateral asset management was brought in-house. As a result, the intent of this Securities Lending Annual Report (**Attachment 1**) is to advise the Committee of the program activity for the calendar year ending December 31, 2001, and the efforts by staff to manage the program restructuring effectively. This report also serves as a precursor to the Securities Lending Business Plan that will be presented in the fall, and will focus on issues impacting the program going forward.

RECOMMENDATION

Staff recommends that the Investment Committee approve the updated Securities Lending Policy Manual and the attached Board Resolution (**Attachment 4**).

Date prepared: April 18, 2002

By:



Glenn Hosokawa
Principal Investment Officer



Michelle Cunningham
Director of Fixed Income

Review & Concur:



Christopher J. Ailman
Chief Investment Officer

California State Teachers' Retirement System
INVESTMENTS OFFICE
FIXED INCOME UNIT

SECURITIES LENDING PROGRAM
ANNUAL REPORT
for
December 31, 2001



California State Teachers'
Retirement System
(CalSTRS)
Investments Office
Fixed Income Unit

Mailing Address:
P.O. Box 163749
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7667 Folsom Blvd.
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Sacramento, CA 95826

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TABLE OF CONTENTS	1
SECURITIES LENDING MANAGEMENT TEAM	2
SECURITIES LENDING	3
EXECUTIVE SUMMARY	4
SECURITIES LENDING PROGRAM STRUCTURE	5
SECURITIES LENDING PROGRAM RESULTS	6
CASH COLLATERAL ASSET MANAGEMENT	7

Fixed Income Staff responsibilities...

- ◆ Implement Board policy relating to securities lending
- ◆ Manage the structure of the program
- ◆ Oversee the agent activities
- ◆ Manage a portion of the cash collateral
- ◆ Review & recommend policy updates

Required skills for program management...

- ◆ Knowledge of asset/liability mgmt methods
- ◆ Awareness of factors that influence the equity/fixed income finance markets
- ◆ Understanding of trading techniques associated with short-term fixed income assets

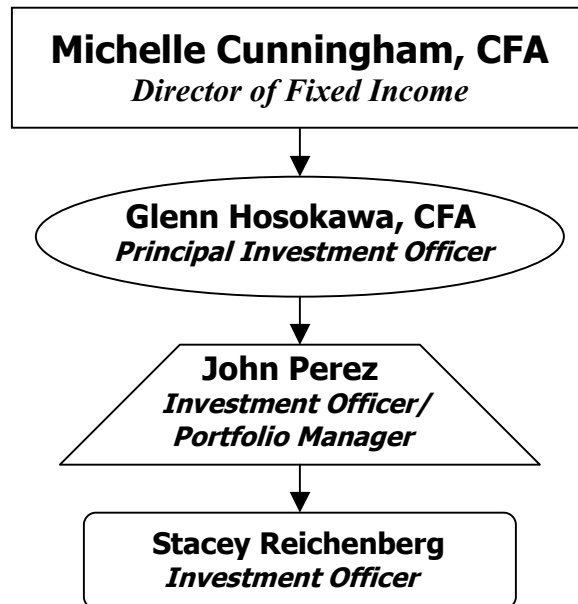
Operations Staff responsibilities...

- ◆ Monitor risk factors
- ◆ Reconcile agent income
- ◆ Compliance review

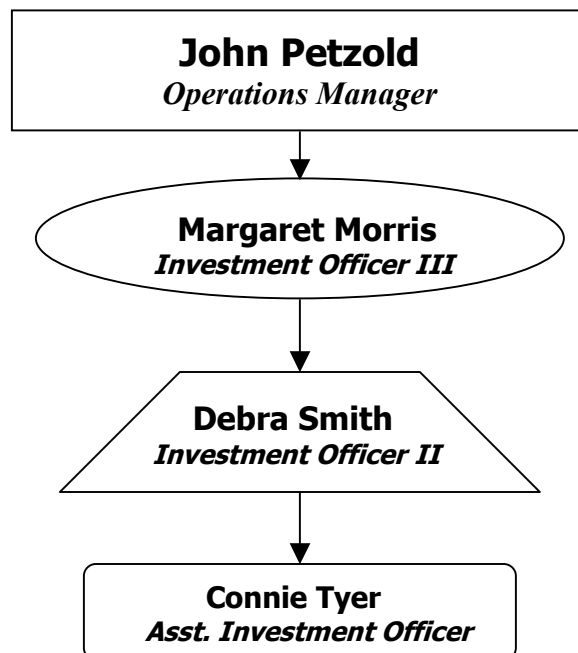


CalSTRS SECURITIES LENDING MANAGEMENT TEAM ...

FIXED INCOME UNIT:



OPERATIONS UNIT:



CalSTRS SECURITIES LENDING...

Securities Lending is an agreement between a lender (CalSTRS) and a borrower to transfer ownership of a security temporarily in order to earn additional income.

A *lendable asset* can be defined as a security that has an established market or demand by borrowers, such as domestic and international equities and fixed income. Cash/money markets and private markets, such as real estate and alternative investments are not considered to be lendable.

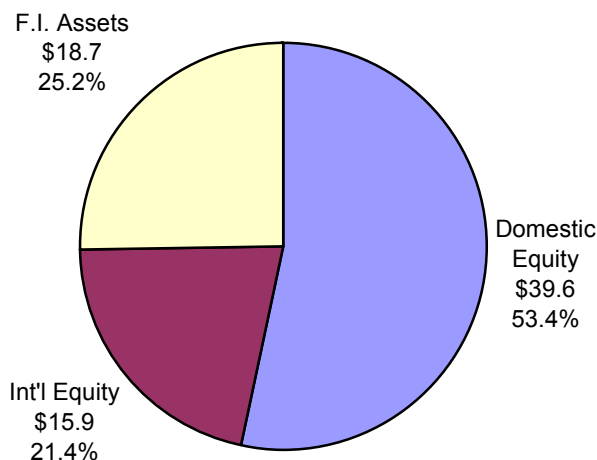
The California State Teachers' Retirement System (CalSTRS, System) Securities Lending Program, which was established in 1988, represents the System's first non-core investment program and was designed to enable the fund to use its existing asset base and investment expertise to generate incremental income. CalSTRS' size and presence in the capital markets make it a prime resource for securities lending. Currently, approximately 75% of the \$100 billion CalSTRS investment portfolio is considered "lendable", in that it includes assets that are in demand by borrowers on a regular basis.

The CalSTRS Securities Lending Program is managed within the Fixed Income Unit by a team of three investment officers. The Operations Unit is also instrumental to the process by performing the compliance function. The Director of Fixed Income oversees the management team, develops and recommends program structure changes, and ensures adherence to Board approved policies.

LENDABLE ASSETS

\$ 74.2 billion

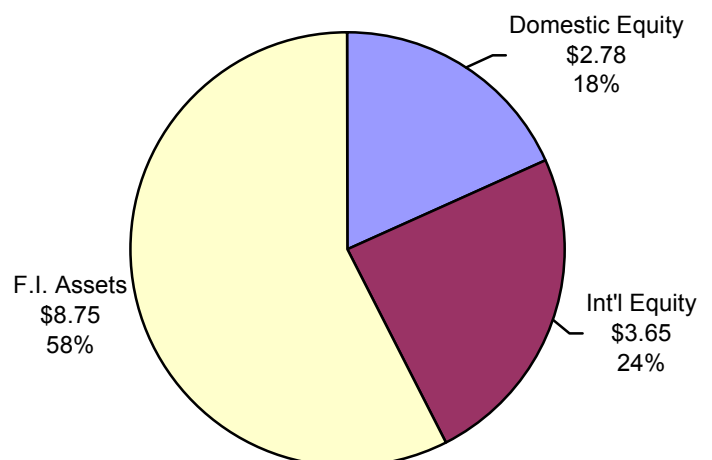
December 31, 2001



ASSETS ON LOAN

\$ 15.18 billion

December 31, 2001



EXECUTIVE SUMMARY

CalSTRS has been involved in the securities lending markets since their early development, and has allocated resources to the Securities Lending Program accordingly. Although securities lending is not one of the core functions in the Fixed Income Unit, it has been viewed as a valuable source of steady incremental income, adding approximately 5 to 6 basis points to the entire fund on a regular basis over the long term. While this income is not risk-free, processes have been put into place to help mitigate the risks associated with securities lending.

Last July, when staff presented its Securities Lending Business Plan to the Investment Committee, the main challenge identified going forward was the management of the quality of the incremental income earned by the program. The Securities Lending Program had just undergone significant restructuring as a result of an RFP for Securities Lending Agents that was issued in 2000. One of the original lenders in the program was terminated, one new lender was added, the assets being lent were redistributed, and a greater portion of the cash collateral asset management was brought in-house. Furthermore, as a result of the restructuring, staff was able to negotiate an improved fee split for the fund. The impact of the restructuring combined with the Federal Reserve lowering short term interest rates an unprecedented 475 basis points during 2001, resulted in an increase of almost \$40 million in income to the program from the previous year.

As staff begins preparation of the Securities Lending Program Business Plan for 2002, it is anticipated that the emphasis over the next year for the program will be to continue to maintain the quality of the incremental income provided by the program. As a result, risk management will be the focus going forward and will likely involve efforts toward enhancing program reporting and monitoring. As an initial step in this regard, CalSTRS has established a Credit Committee that includes senior credit and structure staff that meets on a regular basis to discuss and analyze credit issues within the portfolios. Strategies will also be developed within the cash collateral portfolio to prepare for the likelihood of higher short term interest rates over the intermediate term that will directly impact the securities lending program.

This report presents the highlights of CalSTRS' Securities Lending Program for the calendar year ending December 31, 2001. Included is a description of the new program structure, the income earned as compared to each of the previous years, and an analysis of the performance of each of the cash collateral portfolios.



Michelle Cunningham
Director of Fixed Income
December 31, 2001

Participating Agents

- ◆ State Street Bank
- ◆ Boston Global Advisors (BGA)
- ◆ Metropolitan West
- ◆ CS First Boston

The CalSTRS Securities Lending Program structure...

- ◆ is designed to provide a balance between risk control and diversification
- ◆ is based upon the two sources of income: the lending terms and the return generated from the management of cash taken as collateral for the loan
- ◆ is designed to take advantage of the benefits of both internal and external management in a prudent manner.

CalSTRS has a strategy of using multiple lenders and multiple asset managers in order to benefit from both diversification and competition.



CalSTRS SECURITIES LENDING PROGRAM STRUCTURE...

2000 (PRIOR TO RESTRUCTURING)

State Street Bank	Domestic Equities, Int'l Equities
Bear Stearns	Domestic Equities
MetWest	Fixed Income
BGA	Int'l Equities

2001 (AFTER THE RESTRUCTURING)

State Street Bank	Domestic Equities, Int'l Equities
BGA	Domestic Equities, Int'l Equities
MetWest	Fixed Income
CS First Boston	Fixed Income

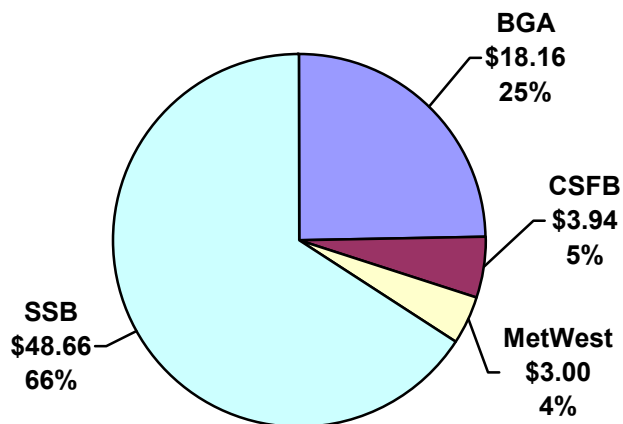
PROGRAM STRUCTURE

State Street Bank	Agent Lender/Cash Collateral Mgr.
BGA	Agent Lender/CalSTRS Cash Mgr.
MetWest	Agent Lender/Cash Collateral Mgr.
CS First Boston	Agent Lender/CalSTRS Cash Mgr.

ASSETS AVAILABLE TO LEND

\$ 73.53 Billion

December 31, 2001



The *performance objective* for the program is to achieve lending income commensurate with: 1) the market demand for the securities made available for lending and, 2) the return earned on the investment of the cash collateral within the guidelines set forth by CalSTRS.

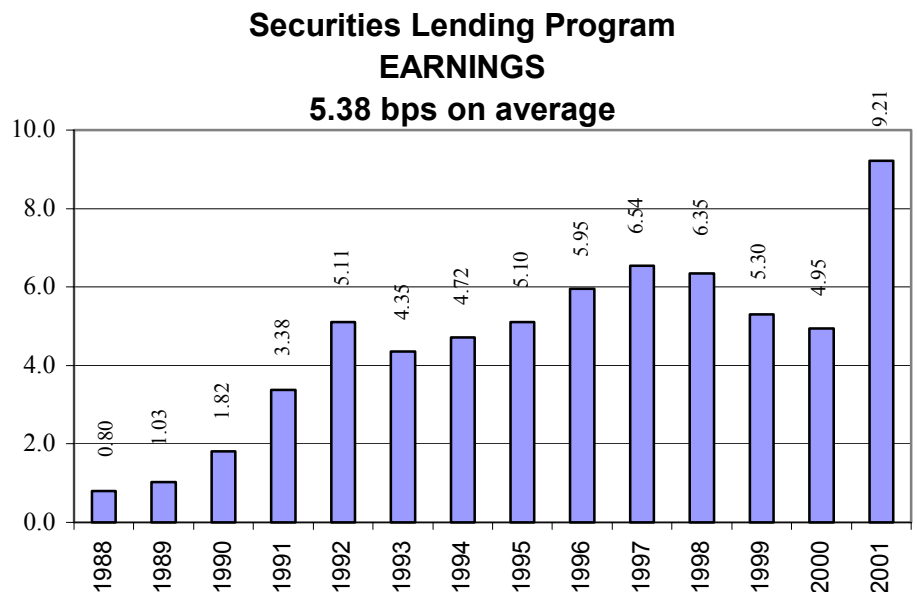
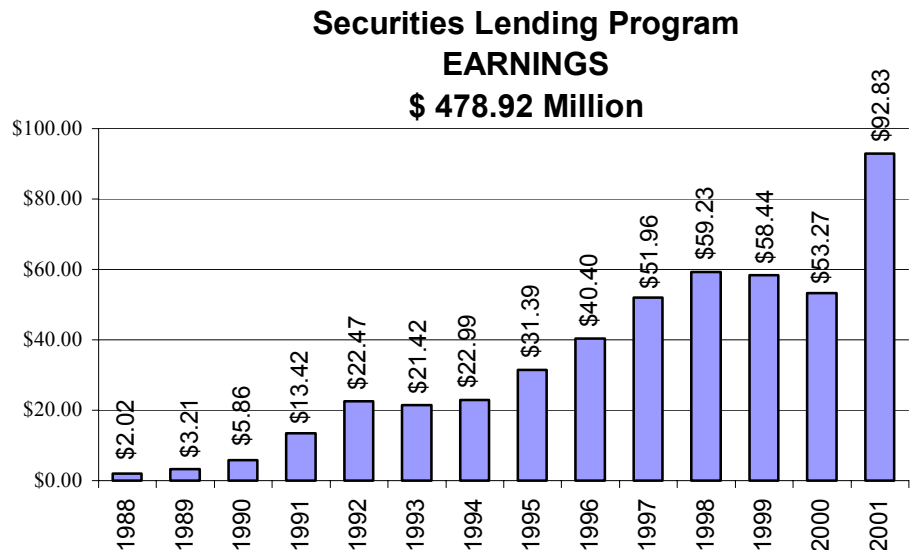
Although securities lending is not one of the core functions within the Fixed Income Unit, it has been viewed as a valuable source of steady incremental income.

Two factors contribute to the net income of the program:

1. the negotiated lending terms at the outset of the loan and,
2. the return generated from the management of the cash taken as collateral for the loan.



CalSTRS SECURITIES LENDING PROGRAM RESULTS...

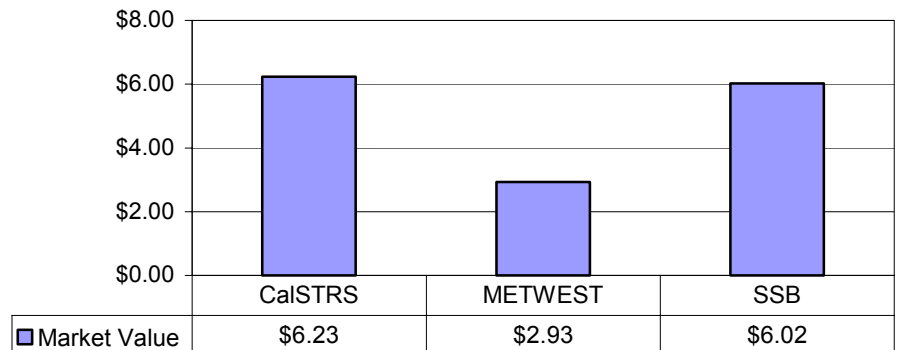


CalSTRS CASH COLLATERAL ASSET MANAGEMENT...

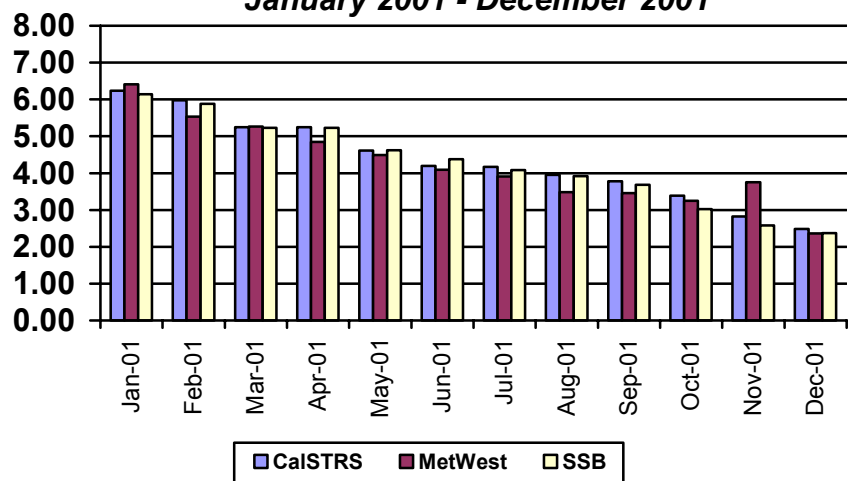
Cash collateral managers have been selected based upon their specific expertise and approach toward lending and cash management.

The Securities Lending Cash Collateral portfolio managers are responsible for investing the cash taken as collateral from loans of securities. Each of the portfolios are diversified among different asset classes, based upon investment guidelines developed by CalSTRS, and emphasize safety of principal and adequate liquidity.

**Cash Collateral Portfolio
MARKET VALUE (in Billions)
December 31, 2001**



**Cash Collateral Portfolio
YIELDS (in bps)
January 2001 - December 2001**



CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

SECURITIES LENDING PROGRAM POLICY MANUAL

INVESTMENT BRANCH
~~May, 1999~~
May, 2002

**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

TABLE OF CONTENTS

Introduction.....	1
CalSTRS Securities Lending Program Policies.....	3
CalSTRS Securities Lending Program Flowchart.....	2
CalSTRS Securities Lending Program Glossary.....	5

California State Teachers' Retirement System Securities Lending Program Policy Manual

INTRODUCTION

Securities Lending is an agreement between a lender and a borrower to transfer ownership of a security temporarily in order to earn additional income. The lender retains ownership rights of the security and is entitled to any distributions that occur with respect to that security during the life of the loan, such as coupon and dividend payments. The borrower backs the agreement by delivering collateral to the lender, either in the form of cash, which is currently the dominant form of collateral in securities lending transactions, or other liquid securities, in an amount that exceeds the market value of the securities borrowed. At the end of the loan or on a periodic basis, the lender is compensated.

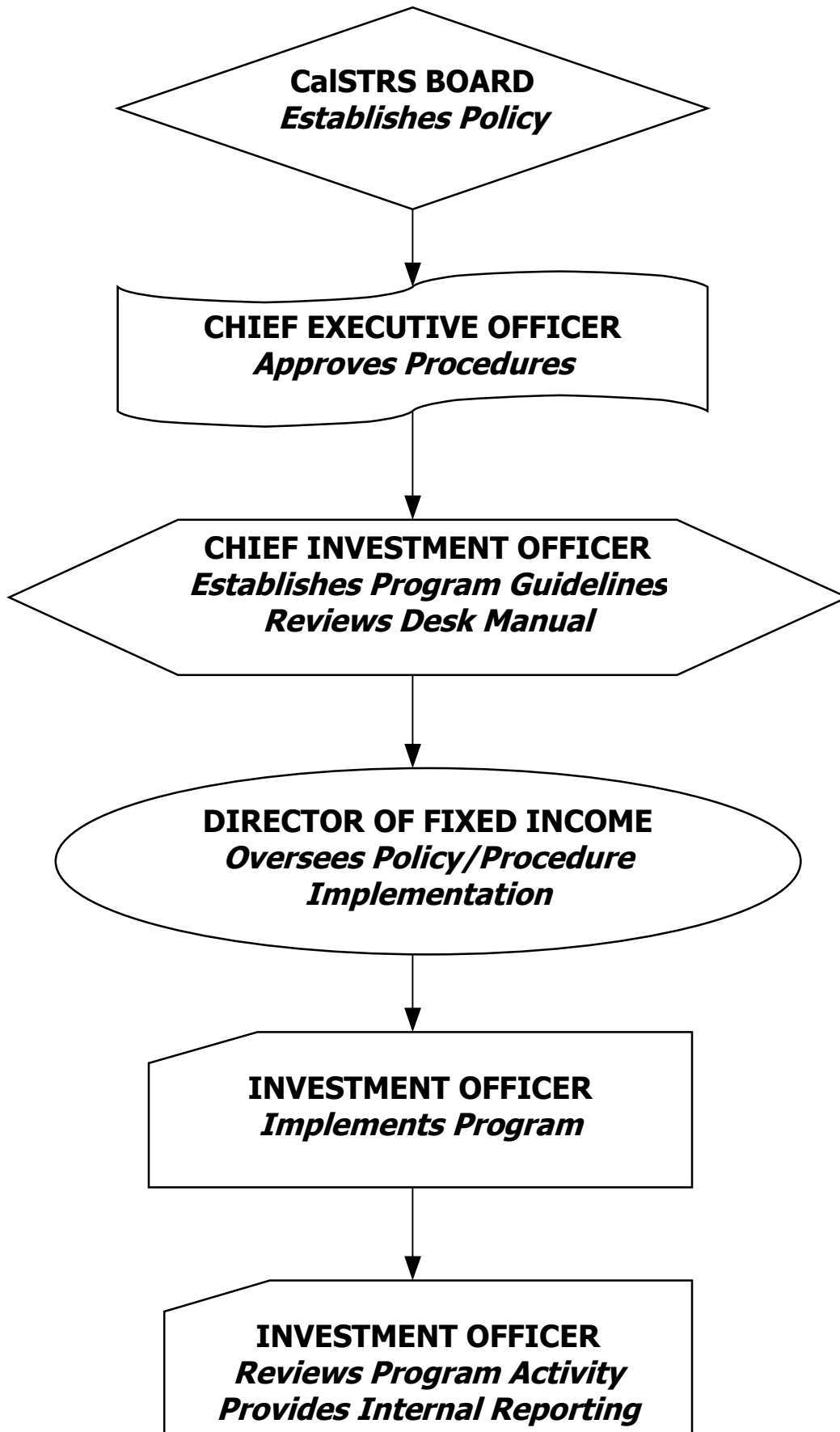
The California State Teachers' Retirement System (CalSTRS, System) has developed a Securities Lending Program designed to enable CalSTRS to use its existing asset base and investment expertise to generate additional income. The income generated from any particular loan is dependent upon two factors: 1) the negotiated lending terms agreed upon at the outset of the loan and, 2) the return generated from the management of the cash taken as collateral for the loan. CalSTRS manages its Securities Lending Program within the following arrangements, in an attempt to provide an appropriate balance between risk control and diversification:

- Agent Lending/Agent Cash Collateral Management
- Agent Lending/CalSTRS Cash Collateral Management
- Principal Lending/CalSTRS Cash Collateral Management

Under the first arrangement, a portion of the Securities Lending Program is managed on an agent basis in which both the lending terms and the collateral management are the responsibility of an external contractor acting as a fiduciary for CalSTRS. Under the second arrangement, the external contractor negotiates the lending terms, while the cash collateral is managed internally within CalSTRS' Fixed Income Unit. Under the final arrangement, a portion of the program is managed on a principal basis, in which the responsibility for both the lending terms and the collateral management belong to CalSTRS Fixed Income staff.

This document outlines the internally approved policies of CalSTRS' Securities Lending Program, which have been designed to set boundaries for the structure and oversight of the management of the program, as well as to manage the risks associated with securities lending. A flow chart is included to provide context for the policies within the general process of implementing the Securities Lending Program. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.

SECURITIES LENDING PROGRAM FLOWCHART



**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

SECURITIES LENDING PROGRAM POLICIES

~~May 1999~~ May 2002

The following represent the approved policies to be utilized in the management of CalSTRS' Securities Lending Program. These policies are designed to set boundaries for the structure and oversight of the management of the program, as well as to manage the risks associated with securities lending. Policies approved by the CalSTRS Board cannot be altered without explicit approval from the CalSTRS Board. *A flow chart is included to provide the context for the policies within the general process of implementing the Securities Lending Program. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.*

1. **Laws and Statutes** - The Securities Lending Program is to be managed in a prudent manner for the sole benefit of CalSTRS' participants and beneficiaries in accordance with the California State Teachers' Retirement Law and other applicable statutes.
2. **Program Objectives** - There are no explicit goals with respect to the nominal amount of income generated by the Securities Lending Program. The performance objective for the program is to achieve lending income commensurate with: 1) the market demand for the securities made available for lending and, 2) the return earned on the investment of the cash collateral within the guidelines set forth by CalSTRS.
3. **Counterparty Risk** – Each loan shall be collateralized by securities and/or cash delivered to CalSTRS' Custodian/Sub-Custodian bank prior to the release of CalSTRS' assets. To protect CalSTRS, the borrower must post collateral in the form of cash and/or other approved securities in an amount that exceeds the market value of the securities borrowed. The margin percentages shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Fixed Income.
4. **Collateralization** - The collateral shall be marked-to-market daily in order to maintain the negotiated margin level. Given the dynamic nature of the securities lending markets, any nontraditional (traditional being defined as cash and U.S. Treasury and U.S. Agency securities denominated in U.S. dollars) collateral must be reviewed and approved by the Director of Fixed Income.
5. **Borrower Concentration** – Borrower diversification shall be reviewed in order to evaluate and control the borrower exposure within the Securities Lending Program. Given the increasingly broad utilization of these firms throughout the CalSTRS Securities Lending Program, this exposure is to be reviewed regularly, with CalSTRS reserving the right to exclude or limit any borrower from the program.

6. **Cash Collateral Portfolios** – Diversification within investment portfolios is critical in order to control risk and maximize returns. Minimum and maximum ranges, with respect to security types, credit exposure, and security maturity, shall be established for the Cash Collateral Portfolios that are being managed both internally and externally. Such ranges shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Fixed Income.
7. **Authorization Limits** – Given that the total amount of trade activity for this program is governed by the investment and securities lending markets, no daily limits with respect to the approval of trade activity within the CalSTRS internally managed Cash Collateral Portfolio shall be established. However, prior to being processed to Operations, all trade tickets shall be authorized and countersigned by two Investment Officers within Fixed Income.
8. **Authorized Signers** – Authorization letters, which indicate who may sign on behalf of CalSTRS shall be delivered to the appropriate parties. Whenever a change in authorized signers occurs, the affected parties shall be notified within 24 hours in the event of termination, and as soon as possible in the event of a newly authorized signer(s).
9. **Business Plan** – The Securities Lending Program will be managed in accordance with a Business Plan, which will be prepared on an annual basis and will describe CalSTRS' goals for the program and will include a plan for achieving such goals over the subsequent twelve month period.
10. **Delegation of Authority** – The management of CalSTRS' Securities Lending Program is delegated to staff within the boundaries established by these policies and the processes described within the Procedures Manual.
11. **Reporting** – Staff will prepare a monthly report for the Chief Investment Officer, which summarizes the activities associated with the management of the Securities Lending Program. The report shall provide information regarding program performance, risk characteristics, and operating statistics.
12. **Board Review** – The Board shall administer and review this policy periodically, as it deems appropriate and in keeping with the investment standard.

ADOPTED BY THE TEACHERS' RETIREMENT BOARD ON FEBRUARY 9, 1994

REVISED ON SEPTEMBER 11, 1996

REVISED ON JANUARY 7, 1998

REVISED ON MAY 5, 1999

REVISED ON MAY 1, 2002

**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

GLOSSARY

AGENCY SECURITIES – Investments issued by federal corporations and federally sponsored corporations that are able to issue debt at a lower cost to such constituencies as farmers, homeowners, and students.

AGENT – An individual or organization who is authorized to act on behalf of another, called the principal.

BORROWER – An individual or organization who borrows securities in return for contracting into an obligation to repay those securities together with a fee payment.

COLLATERAL – An asset, such as U.S. dollars or other liquid securities, which is pledged to a lender in the event that a loan payment cannot be met. The collateral may be appropriated from the borrower and sold in order to fulfill financial obligations.

COUNTERPARTY – An individual or organization on the opposite side of a loan.

CUSTODIAN – An agent, such as a broker or a bank, that stores a customer's investments for safekeeping.

LENDER – An individual or organization that lends securities to a borrower.

MARGIN LEVEL – The amount of cash or eligible securities the borrower will deposit when borrowing securities.

MARKED-TO-MARKET – An adjustment in the valuation of a security to reflect the current market values of the respective securities in the portfolio. This process is also used to ensure that margin accounts are in compliance with maintenance requirements.

PRINCIPAL – The major party in a transaction.

SECURITIES LENDING – An agreement between a lender and a borrower to transfer ownership of a security temporarily in order to earn additional income. The lender retains ownership rights of the security and is entitled to any distributions that occur with respect to that security during the life of the loan, such as coupon and dividend payments. The borrower backs the agreement by delivering collateral to the lender, either in the form of cash, which is currently the dominant form of collateral in securities lending transactions, or other liquid securities, in an amount that exceeds the market value of the securities borrowed.

UNITED STATES TREASURY SECURITIES – Debt issues of the U.S. Government, such as Treasury bills, notes and bonds.

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

SECURITIES LENDING PROGRAM POLICY MANUAL

INVESTMENT BRANCH
May, 2002

**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

TABLE OF CONTENTS

CalSTRS Securities Lending Program Policies.....	1
CalSTRS Securities Lending Program Flowchart.....	3
CalSTRS Securities Lending Program Glossary.....	4

**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

SECURITIES LENDING PROGRAM POLICIES

May 2002

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REVISED ON SEPTEMBER 11, 1996

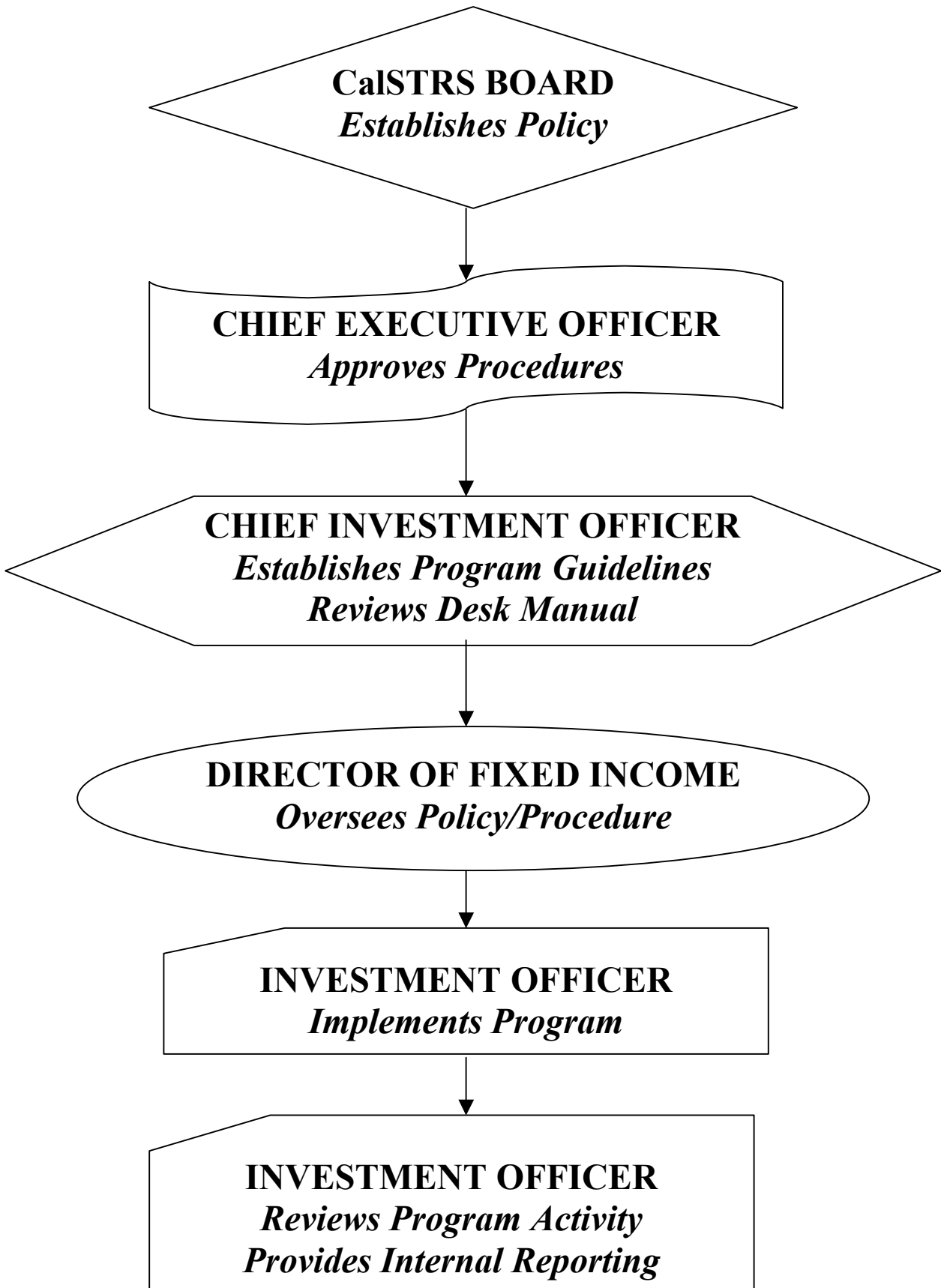
REVISED ON JANUARY 7, 1998

REVISED ON MAY 5, 1999

REVISED ON MAY 1, 2002

California State Teachers' Retirement System
Securities Lending Program Policies

FLOWCHART



**California State Teachers' Retirement System
Securities Lending Program Policy Manual**

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UNITED STATES TREASURY SECURITIES – Debt issues of the U.S. Government, such as Treasury bills, notes and bonds.

RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Securities Lending Program – Investment Policy Revised

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommendations to the Board, investment policy and overall investment strategies for the management of the Teachers' Retirement Fund, a multi-billion dollar public pension plan; and

WHEREAS, the Investment Committee is charged with developing the Fund's Investment Policies and Management Plan including the policies for individual programs, such as the Securities Lending Program; and

WHEREAS, it is the Committee's desire to revise the existing policy for the Securities Lending Program. Therefore, be it

RESOLVED, that the Investment Committee approve the revised Securities Lending Program Investment Policy.

Adopted by:
Investment Committee
on May 1, 2002

Jack Ehnes
Chief Executive Officer